02-20010230.LOF

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 01-0230
Indiana Corporate Income Tax
For Tax Years 1995-1998

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Adjusted Gross Income Tax—Royalty Fee Deduction

Authority: *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S.Ct. 1132 (1943)
Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981)
Sweetland v. Franchise Tax Board, 192 Cal. App. 2d 316 (Cal. App. 1st Dist. 1961)
IC 6-3-2-2(m)

Taxpayer protests the Audit Division's determination that taxpayer's deductions for royalty fees should be disallowed.

II. Adjusted Gross Income Tax—Unitary (Combined) Filing Status

Authority: *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992)
45 IAC 3.1-1-153(b), (c)

Taxpayer protests the Audit Division's determination that taxpayer and its partnership do not enjoy a unitary relationship.

III. Gross Income Tax—Statute of Limitations

Authority: IC 6-8.1-5-2

Taxpayer protests all of the adjustments made by the auditor for the tax periods ending December 31, 1995 and December 31, 1996 on the grounds that the statute of limitations has expired.

IV. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2(c)

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is a Kentucky corporation that operates under the umbrella of its parent corporation (hereinafter, "Parent"). Parent, located in Michigan, is a large retailer of building materials, and an operator of door assembly and truss plants, as well as lumber and building supply distribution centers. Although Parent is located in Michigan, all corporate functions of purchasing, accounting, payroll, trade payables, and property tax payments are performed by a subsidiary corporation headquartered in Ohio (hereinafter, "Ohio Subsidiary"). The Ohio Subsidiary holds the rights to certain trademarks and corporate logos used by other subsidiaries of Parent. The Ohio Subsidiary charges the other subsidiaries with, *inter alia*, a royalty fee for the use of its trademarks and corporate logos.

Taxpayer, a Kentucky corporation and subsidiary of Parent, operates the retail stores located in Kentucky. In 1993, a partnership was formed between taxpayer and an Indiana corporation that was a subsidiary of Parent, for the purpose of holding all of the Indiana assets and retail stores (hereinafter, "Partnership"). Taxpayer holds a one percent (1%) interest in the Partnership. Each year, Taxpayer reports a partnership distributive share in addition to the proceeds from the retail operations of the Kentucky stores.

The Department of Revenue conducted an audit for the tax years in question, and determined that taxpayer erred in deducting the royalty fee expenses that it paid to Parent for the use of trademarks and corporate logos. The Department further determined that whereas the Indiana corporation and the Partnership enjoyed a unitary relationship, taxpayer and the Partnership *did not* enjoy a unitary relationship. As such, the Department classified taxpayer's and the Partnership's distributive share of Indiana income as non-business income. Additional facts will be provided as necessary.

I. <u>Adjusted Gross Income Tax</u>—Royalty Fee Deduction

DISCUSSION

Pursuant to a royalty agreement (hereinafter, "Agreement"), taxpayer agreed to pay the Ohio Subsidiary a one percent (1%) royalty fee for the use of various trademarks and corporate logos. Taxpayer took deductions on its tax returns for the royalty fee expenses. Pursuant to the audit, the auditor disallowed the deduction for royalty expenses. The deduction was disallowed because, according to the auditor, the royalty expenses were charged in a non-uniform manner for the purpose of, *inter alia*, transferring income outside of Indiana. The auditor found that the royalty expenses were charged only to taxpayer, an Indiana subsidiary, and a Pennsylvania subsidiary, and not to the subsidiaries located in Illinois, Michigan, North Carolina, South Carolina, Virginia, Wisconsin, and Ohio.

Taxpayer argues that whether or not the expenses were charged in a uniform manner to all of the operating subsidiaries is of no significance. According to taxpayer, "the deduction is still a valid and appropriate deduction for those divisions that did pay [the expenses to the Ohio Subsidiary]." *Taxpayer's Protest Letter* dated January 17, 2001, pg. 1.

Indiana law gives the Department the authority to apportion or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect said Indiana income. Specifically, IC 6-3-2-2(m) states that:

> "[i]n the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The Department determined that the Ohio Subsidiary was the subsidiary designated by Parent to hold all trademarks and corporate logos. The auditor determined that the royalty fees charged for the use of the trademarks and logos were not paid according to each subsidiary's respective usage. Instead, royalty fee amounts were paid to the Ohio Subsidiary by only a small number of subsidiaries. From this information, the auditor determined that individual usage of the trademarks and logos played no part in whether or not the subsidiary was obligated to pay royalty fees. Therefore, in an effort to ensure that income generated in Indiana was not distorted and unfairly attributed to another state, the auditor disallowed taxpayer's deduction for royalty fees.

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, stating that, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." *Id*. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and or itself is not a valid "business purpose." *See Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 192 Cal. App. 2d 316 (Cal. App. 1st Dist. 1961).

The evidence on file reveals that the Ohio Subsidiary is a separate viable entity with economic and business substance. In addition to holding the rights to trademarks and corporate logos, the Ohio Subsidiary controls the operations of all of the Indiana retail stores. All corporate functions and day-to-day operations, as well as all asset and inventory purchases, accounting, payroll, invoicing, payables, and property tax payments are performed at the Ohio Subsidiary's headquarters. Although the Ohio Subsidiary and taxpayer share corporate officers, taxpayer is a separate Kentucky corporation that holds a one percent (1%) interest in the Partnership in addition to operating the retail stores located in Kentucky.

The Ohio Subsidiary charged a one percent (1%) royalty fee to taxpayer for its use of the trademarks and logos. Taxpayer paid the royalty fee and deducted the fee from its gross income as a business expense. Based on the available evidence, both the Ohio Subsidiary and taxpayer are viable, separate business entities.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax—Unitary (Combined) Filing Status

DISCUSSION

Taxpayer next argues that the Audit Division erred in finding that taxpayer did not enjoy a unitary relationship with the Partnership. Audit determined that taxpayer's corporate activities and the Partnership's activities did not constitute a unitary business under established standards because taxpayer merely held a one percent (1%) investment interest in the Partnership and performed no administrative or management functions for the Partnership.

45 IAC 3.1-1-153 specifically addresses the manner in which to treat a corporate partner with respect to partnership income. This regulation is also determinative of how to determine whether or not a unitary relationship exists. 45 IAC 3.1-1-153(b) reads in part that if a

> "corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors . . ."

(Alternatively, 45 IAC 3.1-1-153(c) sets forth the means by which one attributes partnership income in those situations where the corporate partner's activities and the partnership's activities *do not* demonstrate a unitary business relationship.) This section further indicates that to establish the existence of a unitary operation, the taxpayer must demonstrate that the relationship between the taxpayer itself and the partnership meet the established characteristics of a unitary relationship.

The Supreme Court over the years has developed a three-part test in determining whether a unitary relationship exists: common ownership, common management, and common use or operation. *See*, *e.g.*, *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992). To establish a unitary relationship, taxpayer must demonstrate at the very least that taxpayer has operational control of the partnership or that management of the partnership is centralized with management of the corporation. Specifically, the information in taxpayer's file shows that during the audit period, taxpayer held a one percent (1%) interest in the Partnership, having contributed ten thousand dollars ($10,000) at the formation of the Partnership. Given taxpayer's status as a minor partner in the Partnership, taxpayer would have to have been given an unusual amount of control from the general partner (i.e., the corporation which held a ninety-nine percent (99%) interest in the Partnership). No such unusual amount of control was given to taxpayer by the general partner. As taxpayer has failed to meet the first prong of the three-part test, taxpayer has failed to establish that it enjoys a unitary relationship with the Partnership.

FINDING

Taxpayer's protest is denied.

III. Gross Income Tax—Statute of Limitations

DISCUSSION

Taxpayer protests the adjustments made by the auditor for the tax periods ending December 31, 1995 and December 31, 1996 on the grounds that the statute of limitations has expired. According to taxpayer's records, the statute of limitations expired on August 30, 2000.

The time limitation on issuance of a proposed assessment is governed by IC 6-8.1-5-2 which provides in pertinent part:

> Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or any of the following:

> (1) the due date of the return; or
>
> (2) in the case of a return filed for the state gross retail or use tax . . . the end of the calendar year which contains the taxable period for which the return is filed.
>
> . . .
>
> (e) If a person files a fraudulent, unsigned, or substantially blank return, or if a person does not file a return, there is no time limit within which the department must issue its proposed assessment.

IC 6-8.1-5-2(a), (e).

The evidence on file establishes that on April 14, 2000, taxpayer's Chief Financial Officer executed two Forms AD-10, Agreement to Extension of Time, which stated respectively that any tax due by taxpayer for the tax year 1995 and for the tax year 1996 could be assessed at any time on or before August 30, 2000. On July 28, 2000, taxpayer's Chief Financial Officer executed two additional Forms AD-10 extending the time limit of assessment for tax years 1995 and 1996 until October, 15, 2000. Finally, on September 8, 2000, taxpayer's Chief Financial Officer executed one Form AD-10 extending the time limit of assessment for tax year 1996 until January 1, 2001.

The auditor completed the audit on September 9, 2000. The notice for proposed assessments was issued October 18, 2000. The only assessment was for the IT-20 tax return for the period ending December 31, 1998. In as much as the only assessment that the Department issued against taxpayer was for the tax year ending December 31, 1998, no error occurred and the statute of limitations protest is rendered moot.

FINDING

As it has been determined that the Audit Division made no adjustments to taxpayer's tax accounts and proposed no assessments against taxpayer for the tax periods ending December 31, 1995, December 31, 1996, or December 31, 1997, rendering this issue moot.

IV. Tax Administration—Abatement of Penalty

DISCUSSION

The Audit division determined that a ten percent (10%) negligence penalty should be imposed upon taxpayer. Taxpayer disagrees with the imposition of said penalty.

Under IC 6-8.1-10-2.1(d), the Department is empowered to waive the ten-percent negligence penalty if the taxpayer can establish that its failure to pay the tax deficiency was due to reasonable cause and not due to willful neglect. Under 45 IAC 15-11-2(c), in order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. Ignorance of the listed tax laws, rules, and/or regulations is treated as negligence. Factors which may be considered to determine reasonable cause include the nature of the tax involved, judicial precedents set by Indiana courts, judicial precedents established by jurisdictions outside Indiana, published Department instructions, information bulletins, letters of findings, rulings, and letters of advice. 45 IAC 15-11-2(c).

The Audit Division imposed the negligence penalty because taxpayer failed to accurately report its taxable income. Taxpayer points to no precedents, instructions, bulletins, statutes, or regulations which justify its failure to pay the full amount of its state tax. Even assuming that taxpayer’s failure to pay the appropriate amount of tax was entirely attributable to an innocent mistake, taxpayer still is unable to establish a "reasonable cause" for that error.

FINDING

Taxpayer's protest is respectfully denied.

HLS/JM/MR-021804